

ORIGINAL

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EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

2009 DEC -8 P 3:09

Arizona Corporation Commission

KRISTIN K. MAYES, Chairman
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SANDRA D. KENNEDY
PAUL NEWMAN
BOB STUMP

AZ CORP COMMISSION
DOCKET CONTROL

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DEC - 8 2009

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IN THE MATTER OF THE APPLICATION OF
SUNRISE WATER CO., AN ARIZONA
CORPORATION, FOR A DETERMINATION OF
THE CURRENT FAIR VALUE OF ITS UTILITY
PLANT AND PROPERTY AND FOR
INCREASES IN ITS RATES AND CHARGES
BASED THEREON FOR UTILITY SERVICE

DOCKET NO. W-02069A-08-0406

EXCEPTIONS OF SUNRISE WATER COMPANY

1 Pursuant to A.A.C. R14-3-110(B), Sunrise Water Company ("Sunrise") hereby submits
2 its Exceptions to the December 2, 2009, Recommended Opinion and Order ("ROO").

3 Sunrise has approached this case with the goal of reducing issues through compromise
4 whenever possible. Sunrise appreciates that efforts of Staff to compromise and notes that the
5 ALJ has proposed compromise positions for several of the remaining disputed items. Although
6 disappointed that its position did not prevail on the remaining contested issues—particularly the
7 issue of hydrant-water sales-normalization—Sunrise will continue its effort to reduce issues by
8 limiting its exceptions to the single issue of the recovery of pro-forma income-tax expense and
9 the impact of that disallowance on operating margin.

10 **Exception 1 – Income Tax Expense¹**

11 The ROO would disallow income-tax expense for Sunrise. This would be poor public
12 policy.

13 The Commission should not discriminate against S-Corps or LLCs by disallowing their
14 recovery of demonstrated income-tax expense, when it allows subsidiaries or operating divisions

¹ This issue has been extensively briefed, so Sunrise will only summarize its argument here.

1 of C-Corps to recover income-tax expense. The equities are identical. In each case, the
2 regulated entity is not the entity that pays the allowed income-tax expense; rather, the regulated
3 entity passes income-tax liability on to the ultimate taxpayer, who must make the required
4 income-tax payments.

5 In the case of either an S-Corp or a C-Corp that is part of a holding company (as most are
6 in this state), it is the ultimate shareholder that pays the taxes. The Commission does not
7 calculate the actual tax liability as part of a rate case. Rather, the Commission calculates
8 hypothetical tax liability as if the entity were a stand-alone company. There is no justifiable
9 reason that the Commission should allow APS, Southwest Gas, Arizona-American Water, or
10 Tucson Electric to recover hypothetical tax expense and to deny Sunrise such recovery.

11 As recognized by many other courts and commissions, income-tax expense is a genuine
12 cost of doing business as a regulated utility. The Commission came to this same conclusion in
13 the 1997 case of Camp Verde Water System, Inc., Decision No. 60105, dated March 19, 1997.
14 In this case the Commission allowed recovery of income-tax expense by an S-Corp, where the
15 bank would not loan funds if income-tax expenses were not allowed.

16 The Camp Verde case highlights the economic reality that S-Corps have real income tax
17 expenses. Because the bank's investment would only be repaid with after-tax dollars, it insisted
18 on recovery of income-tax expense in rates. The Commission acknowledged economic reality
19 and allowed Camp Verde to recover expected income-tax expense.

20 Put another way, only the funds left over after paying taxes and other business expenses
21 are available to fund additional plant investment. If income-tax expense were not recoverable,
22 the effect would be to reduce the allowed return on equity and diminish the funds available for
23 plant investment. As the Commission is well aware, small water companies, many of which are
24 LLCs or S-Corps, are struggling to raise the funds they require to invest in new infrastructure.

1 The ROO states that there is no documentary evidence that Sunrise's income was passed
2 through to Mr. Campbell.² This is technically true, but Mr. Jones did testify that:

3 Mr. Campbell paid income taxes on Sunrise's test year taxable income of
4 \$258,646 at a combined federal and state marginal rate of 32.5% and an overall
5 effective rate of 23.0%.³

6 This evidence is uncontroverted. Staff did not conduct any discovery concerning this statement
7 or challenge it in any way, so no further documentation was supplied. If Staff had requested
8 documentation, Sunrise could have provided a copy of Sunrise Water's test-year (2007) 1120S
9 tax return and Schedule K-1. Copies of these documents are attached as Exhibit A. The return
10 confirms Mr. Jones' testimony that Sunrise passed through \$258,646 of taxable income to Mr.
11 Campbell.

12 That Sunrise actually generated and distributed taxable income to its shareholder is a
13 critical distinction between this and other cases being considered by the Commission. For
14 example, Sunrise is aware that there is a current rate case involving Johnson Utilities, LLC
15 ("Johnson").⁴ In that case, Johnson is also asking to recover income-tax expense. However,
16 Johnson provided no evidence that it generated any taxable income or that its members were
17 responsible for paying any income taxes.

18 Johnson may actually be provided better treatment by the Commission than the ROO
19 would provide for Sunrise. According to Staff, Johnson's water rate base is negative and its
20 wastewater rate base is barely positive. Because of inadequate rate bases, Staff is proposing that
21 Johnson be provided a 10-percent operating margin, the alternative ratemaking treatment
22 traditionally provided for investment-poor water utilities.⁵

23 In contrast to Johnson and many other Arizona water utilities, Sunrise has made a
24 significant investment in water infrastructure. Mr. Campbell has provided Sunrise the funds
25 needed to invest in water infrastructure, including arsenic-remediation facilities. As a result,

² ROO at 37:8-9.

³ Ex. A-15 at 16:18-20.

⁴ Docket No. WS-02987A-08-0180.

⁵ See Staff's final schedules in Docket No. WS-02987A-08-0180, dated October 30, 2009.

1 Sunrise has a substantial rate base and, although it was under-earning, it was able to generate
2 verifiable taxable income in the test-year. Yet, the ROO would provide Sunrise an operating
3 margin of just 7.43 percent, much worse than Staff's proposed 10-percent operating margin for
4 Johnson.⁶

5 Disallowing income-tax expense reduces Sunrise's operating margin below the minimum
6 of 10 percent typically recommended for investment-poor water utilities.⁷ This supports the
7 equity of the Commission recognizing tax-expense for an S-Corp or an LLC when the utility has
8 sufficient rate base to allow for traditional rate of return rate-making, and it can provide evidence
9 that it actually has generated taxable income that it passes on to a member or shareholder.

10 The evidence is clear that Sunrise generated taxable income in the test year and passed it
11 on to Mr. Campbell, who was responsible for paying the resulting taxes. Mr. Campbell has also
12 invested enough of his own funds into Sunrise so that it has a large enough rate base to allow
13 traditional rate-making. Given these two factors, it is appropriate to recover adjusted test-year
14 income-tax expense and to gross up the revenue requirement for income-taxes. Exhibit B is a
15 proposed amendment to this effect.

16 **Exception 2 – Operating Margin**

17 As discussed above, the ROO would provide Sunrise an operating margin of just 7.43%,
18 much less than the normal 10%. If the Commission will not allow Sunrise to recover income
19 tax expense, then Sunrise asks the Commission to at least treat it no worse than it treats water
20 companies that have not made sufficient investment in plant to generate a positive rate base. Mr.
21 Campbell has set a good example by investing the funds needed to build and maintain a modern,
22 safe water utility, including arsenic-remediation facilities. This is exactly the behavior that the
23 Commission is trying to encourage from utility investors.

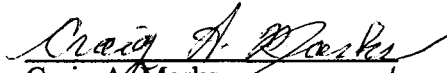
⁶ Operating Margin = Operating Income/Revenue Requirement, or $\$104,020 \div \$1,399,237 = 7.43\%$. See ROO at 40:23-25.

⁷ With income tax recovery, Sunrises pre-tax operating margin is 11.18 percent.

1 Providing Sunrise less than a 10-percent operating margin would send a message to
2 Arizona utilities and their investors that the Commission will treat utilities making needed
3 infrastructure investments worse than utilities that have neglected their rate bases. This would be
4 the wrong message to send.

5 Exhibit C is a proposed amendment that would adjust Sunrise's rates to provide it a 10%
6 operating margin.

1 RESPECTFULLY SUBMITTED on December 8, 2009.
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3
4

5 
6 Craig A. Marks *by Marvin E. Collins*
7 Craig A. Marks, PLC
8 10645 N. Tatum Blvd
9 Suite 200-676
10 Phoenix, Arizona 85028
11 (480) 367-1956
12 Craig.Marks@azbar.org
13 Attorney for Sunrise Water Company
14

Original and 13 copies filed
on December 8, 2009, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies of the foregoing delivered on
December 8, 2009, to:

Wesley C. Van Cleve
Attorney, Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Steve Olea
Director; Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Sarah N. Harping
Administrative Law Judge
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

By:

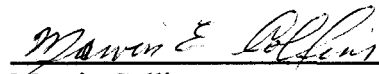

Marvin Collins

EXHIBIT A

2007 SUNRISE WATER FORM 1120S AND SCHEDULE K-1

Form **1120S**Department of the Treasury
Internal Revenue Service**U.S. Income Tax Return for an S Corporation**

► **Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.**
► **See separate instructions.**

OMB No. 1545-0130

2007

For calendar year 2007 or tax year beginning , 2007, ending ,

A Selection effective date 8/05/1969	Use the IRS label. Otherwise, print or type.	SUNRISE WATER COMPANY 9098 WEST PINNACLE PEAK ROAD PEORIA, AZ 85383	D Employer identification number 86-0222187
B Business activity code number (see instrs) 221300			E Date incorporated 4/28/1968
C Check if Sch M-3 attached <input type="checkbox"/>			F Total assets (see instructions) \$ 8,692,629.

G Is the corporation electing to be an S corporation beginning with this tax year? ☐ Yes ☒ No If 'Yes,' attach Form 2553 if not previously filed

H Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change
(4) ☐ Amended return (5) ☐ S election termination or revocation

I Enter the number of shareholders in the corporation at the end of the tax year **1****Caution. Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.**

INCOME	1a Gross receipts or sales.. 1,347,641.	b Less returns and allowances..	c Bal	1c 1,347,641.
	2 Cost of goods sold (Schedule A, line 8).....			2
	3 Gross profit. Subtract line 2 from line 1c.....			3 1,347,641.
	4 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797).....			4
	5 Other income (loss) (attach statement).....	See Statement 1		5 11,574.
	6 Total income (loss). Add lines 3 through 5.....			6 1,359,215.
DEDUCTIONS	7 Compensation of officers.....			7 125,000.
	8 Salaries and wages (less employment credits).....			8 257,937.
	9 Repairs and maintenance.....			9 26,294.
	10 Bad debts.....			10
	11 Rents.....			11
	12 Taxes and licenses.....			12 72,601.
	13 Interest.....			13 2,161.
	14 Depreciation not claimed on Schedule A or elsewhere on return (attach Form 4562).....			14 118,211.
	15 Depletion (Do not deduct oil and gas depletion.).....			15
	16 Advertising.....			16 1,427.
	17 Pension, profit-sharing, etc, plans.....			17
	18 Employee benefit programs.....			18
	19 Other deductions (attach statement).....	See Statement 2		19 484,745.
	20 Total deductions. Add lines 7 through 19.....			20 1,088,376.
	21 Ordinary business income (loss). Subtract line 20 from line 6.....			21 270,839.
TAX AND PAYMENTS	22a Excess net passive income or LIFO recapture tax (see instructions).....	22a		
	b Tax from Schedule D (Form 1120S).....	22b		
	c Add lines 22a and 22b (see instructions for additional taxes).....			22c
	23a 2007 estimated tax payments and 2006 overpayment credited to 2007.....	23a		
	b Tax deposited with Form 7004.....	23b		
	c Credit for federal tax paid on fuels (attach Form 4136).....	23c		
	d Add lines 23a through 23c.....			23d
	24 Estimated tax penalty (see instructions). Check if Form 2220 is attached.			24
	25 Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed.....			25 0.
	26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid.....			26
27 Enter amount from line 26 Credited to 2008 estimated tax		Refunded	27	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer

Date

Title

May the IRS discuss this return with the preparer shown below (see instructions)?

☒ Yes ☐ No**Paid Preparer's Use Only**

Preparer's signature

Date

Check if self-employed ☐

Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code

Bernard & Stallman, CPAs, P.C.
8125 North 23rd Ave., Ste. 232
Phoenix, AZ 85021

EIN **86-0643172**Phone no. **(602) 943-2727****BAA For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.**

SPSA0105L 12/26/07

Form **1120S** (2007)

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach statement)	4	
5	Other costs (attach statement)	5	
6	Total. Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:

(i) ☐ Cost as described in Regulations section 1.471-3

(ii) ☐ Lower of cost or market as described in Regulations section 1.471-4

(iii) ☐ Other (Specify method used and attach explanation.)

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c). ☐ Yes ☐ No

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970). ☐ Yes ☐ No

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d** ☐ Yes ☐ No

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☐ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If 'Yes,' attach explanation. ☐ Yes ☐ No

Schedule B Other Information (see instructions)

	Yes	No
1 Check accounting method: a <input checked="" type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) _____		
2 See the instructions and enter the: a Business activity UTILITY b Product or service WATER		
3 At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If 'Yes,' attach a statement showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) if 100% owned, was a QSub election made?		X
4 Has this corporation filed, or is it required to file, a return under section 6111 to provide information on any reportable transaction?		X
5 Check this box if the corporation issued publicly offered debt instruments with original issue discount. <input type="checkbox"/> If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.		
6 If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years. \$ _____		
7 Enter the accumulated earnings and profits of the corporation at the end of the tax year. \$ _____		
8 Are the corporation's total receipts (see instructions) for the tax year and its total assets at the end of the tax year less than \$250,000? If 'Yes,' the corporation is not required to complete Schedules L and M-1		X

Schedule K Shareholders' Pro Rata Share Items

	Total amount
1 Ordinary business income (loss) (page 1, line 21)	1 270,839.
2 Net rental real estate income (loss) (attach Form 8825)	2
3a Other gross rental income (loss)	3a
b Expenses from other rental activities (attach statement)	3b
c Other net rental income (loss). Subtract line 3b from line 3a	3c
4 Interest income	4 54,790.
5 Dividends: a Ordinary dividends	5a
b Qualified dividends	5b
6 Royalties	6
7 Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7
8a Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a
b Collectibles (28%) gain (loss)	8b
c Unrecaptured section 1250 gain (attach statement)	8c
9 Net section 1231 gain (loss) (attach Form 4797)	9
10 Other income (loss) (see instructions)	10

Form 1120S (2007)

	Shareholders' Pro Rata Share Items (continued)	Total amount
Deductions	11 Section 179 deduction (attach Form 4562)	11 66,983.
	12a Contributions	12a
	b Investment interest expense	12b
	c Section 59(e)(2) expenditures (1) Type ▶ _____ (2) Amount ▶ _____	12c (2)
	d Other deductions (see instructions) .. Type ▶ _____ See Statement 3	12d
Credits	13a Low-income housing credit (section 42(j)(5))	13a
	b Low-income housing credit (other)	13b
	c Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)	13c
	d Other rental real estate credits (see instrs) Type ▶ _____	13d
	e Other rental credits (see instrs) Type ▶ _____	13e
	f Credit for alcohol used as fuel (attach Form 6478)	13f
	g Other credits (see instructions) .. Type ▶ _____	13g
Foreign Transactions	14a Name of country or U.S. possession	
	b Gross income from all sources	14b
	c Gross income sourced at shareholder level	14c
	Foreign gross income sourced at corporate level	
	d Passive category	14d
	e General category	14e
	f Other (attach statement)	14f
	Deductions allocated and apportioned at shareholder level	
	g Interest expense	14g
	h Other	14h
	Deductions allocated and apportioned at corporate level to foreign source income	
	i Passive category	14i
	j General category	14j
	k Other (attach statement)	14k
Other information		
l Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	14l	
m Reduction in taxes available for credit (attach statement)	14m	
n Other foreign tax information (attach statement)		
Alternative Minimum Tax (AMT) Items	15a Post-1986 depreciation adjustment	15a 14,978.
	b Adjusted gain or loss	15b
	c Depletion (other than oil and gas)	15c
	d Oil, gas, and geothermal properties — gross income	15d
	e Oil, gas, and geothermal properties — deductions	15e
	f Other AMT items (attach statement)	15f
Items Affecting Shareholder Basis	16a Tax-exempt interest income	16a
	b Other tax-exempt income	16b
	c Nondeductible expenses	16c 2,392.
	d Property distributions	16d
	e Repayment of loans from shareholders	16e
Other Information	17a Investment income	17a 54,790.
	b Investment expenses	17b
	c Dividend distributions paid from accumulated earnings and profits	17c
	d Other items and amounts (attach statement)	
Reconciliation	18 Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and lines 14l ..	18 258,646.

BAA

Form 1120S (2007)

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1	Cash		1,826,814.		460,622.
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach stmt) See St. 4		265,290.		135,371.
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets	5,805,088.		8,728,800.	
b	Less accumulated depreciation	1,461,268.	4,343,820.	1,646,462.	7,082,338.
11a	Depletable assets				
b	Less accumulated depletion				
12	Land (net of any amortization)		873,264.		873,264.
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
14	Other assets (attach stmt) See St. 5		88,013.		141,034.
15	Total assets		7,397,201.		8,692,629.
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach stmt) See St. 6		2,178,634.		296,072.
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement) See St. 7		3,266,289.		6,081,937.
22	Capital stock		10,000.		10,000.
23	Additional paid-in capital		1,807,714.		1,913,802.
24	Retained earnings		134,564.		390,818.
25	Adjustments to shareholders' equity (att stmt)				
26	Less cost of treasury stock				
27	Total liabilities and shareholders' equity		7,397,201.		8,692,629.

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more — see instructions

1	Net income (loss) per books	256,254.	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize):		a	Tax-exempt interest \$	
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12, and 14i (itemize):		6	Deductions included on Schedule K, lines 1 through 12, and 14i, not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Travel and entertainment \$	2,392.	7	Add lines 5 and 6	0.
4	Add lines 1 through 3	258,646.	8	Income (loss) (Schedule K, ln 18). Ln 4 less ln 7	258,646.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	231,555.	-96,991.
2	Ordinary income from page 1, line 21	270,839.	
3	Other additions See Statement 8	54,790.	
4	Loss from page 1, line 21		
5	Other reductions See Statement 9	(69,375.)	
6	Combine lines 1 through 5	487,809.	-96,991.
7	Distributions other than dividend distributions		
8	Balance at end of tax year. Subtract line 7 from line 6	487,809.	-96,991.

Schedule K-1
(Form 1120S)
2007

 Department of the Treasury
 Internal Revenue Service

For calendar year 2007, or tax

year beginning _____, 2007

ending _____, _____

☐ Final K-1

☐ Amended K-1

OMB No. 1545-0130

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See page 2 of form and separate instructions.

Part I Information About the Corporation
A Corporation's employer identification number
 86-0222187

B Corporation's name, address, city, state, and ZIP code
 SUNRISE WATER COMPANY
 9098 WEST PINNACLE PEAK ROAD
 PEORIA, AZ 85383

C IRS Center where corporation filed return
 Ogden, UT

Part II Information About the Shareholder
D Shareholder's identifying number
 511-28-0339

E Shareholder's name, address, city, state, and ZIP code
 J.D. CAMPBELL
 9098 W. PINNACLE PEAK ROAD
 PEORIA, AZ 85345

F Shareholder's percentage of stock ownership for tax year 100 %

Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	13	Credits
	270,839.		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
	54,790.		
5a	Ordinary dividends		
5b	Qualified dividends	14	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	15	Alternative minimum tax (AMT) items
		A	14,978.
11	Section 179 deduction	16	Items affecting shareholder basis
	66,983.	C	2,392.
12	Other deductions		
P	203,856.		
Q	382,937.		
		17	Other information
		A	54,790.

*See attached statement for additional information.

FOR IRS USE ONLY

BAA For Paperwork Reduction Act Notice, see Instructions for Form 1120S.

Schedule K-1 (Form 1120S) 2007

Shareholder 1

**SUGGESTED INCOME-TAX AMENDMENT
TO RECOMMENDED OPINION AND ORDER**

Page 32, Line 2,

DELETE last sentence of paragraph.

Page 36, Line 9,

DELETE paragraph 88 and REPLACE with the following paragraphs:

88. This appears to be the first time that the Commission has been faced with the issue of whether a Class A or B water utility, which is also an S corporation, should be allowed to recover income-tax expense.¹ On balance we are persuaded that, based on the facts of this case, Sunrise should be allowed to recover this expense and that its revenue requirement should be grossed up for the effect of income taxes. It is true that Sunrise does not directly pay income taxes, but this is equally true, for example, for APS (corporate subsidiary) and for Arizona-American Water Company's Sun City Water Division (operating division). In each case, income-tax liability is passed on to the ultimate owner for payment. Further, Sunrise has demonstrated that it generated income-tax liability in the test year and that Mr. Campbell was responsible for the resulting income taxes.² Finally, Sunrise has a positive rate base that is sufficient for traditional ratemaking, as long as income-tax expense is recognized.³ Given these circumstances, it is appropriate for Sunrise to recover income-tax expense and to gross up its revenue requirement for the effect of income taxes.

89. We will approve Sunrise's alternate methodology for computing income-tax expense. This method assumes that the S corporation had just one shareholder (which it does), who filed a return as married filing jointly and derived all of his or her income from the regulated

¹ The *Camp Verde* case appears to have involved a Class C utility.

² Ex. A-15 at 16:18-20.

³ Absent recovery of income-tax expense, this order would only provide Sunrise an operating margin of 7.43%, which is substantially less than that provided for water utilities with minimal or negative rate bases.

EXHIBIT B

SUGGESTED INCOME-TAX AMENDMENT TO RECOMMENDED OPINION AND ORDER

utility. This results in a lower income-tax expense than if we computed the taxes as if Sunrise were a stand-alone taxable entity. In addition, as proposed by Sunrise and recommended by Staff, we will allow recovery of accumulated deferred income tax ("ADIT") as an addition to rate base. However, we will calculate ADIT using the combined federal and state effective tax rate of 30.0791% from Sunrise's alternate methodology, rather than the corporate tax rate recommend by Sunrise and Staff. This results in the addition of \$99,891 in ADIT rather than the \$143,632 proposed by Sunrise and Staff. The resulting income-tax expense is \$49,045

RENUMBER subsequent paragraphs.

Page 38, Line 21,

DELETE last sentence of existing Paragraph 91.

Page 40, Line 9,

DELETE first sentence of existing paragraph 98 and REPLACE with the following sentence:

We find the Sunrise's OCRB is \$1,140,093, calculated by modifying Staff's recommended OCRB of \$1,183,834 to exclude \$43,741 in ADIT.⁴

Page 40, line 12,

DELETE the last sentence of paragraph 98 and REPLACE with the following sentence:

Thus, we find that Sunrise's FVRB is equivalent to its OCRB of \$1,140,093.

⁴ \$43,741 is the difference between \$143,632 in ADIT recommended by Staff and \$99,891 allowed herein.

**SUGGESTED INCOME-TAX AMENDMENT
TO RECOMMENDED OPINION AND ORDER**

Page 40, Lines 20 through 22,

DELETE Paragraph 101 in its entirety.

Page 40, line 23,

DELETE first sentence of existing paragraph 102 and REPLACE with the following sentence:

Based on the adjustments made herein, we find that Sunrise should be permitted to recover operating income of \$114,009 and total operating expenses of \$1,344,262, for an overall revenue requirement of \$1,458,272.

Page 40, line 27,

DELETE paragraph 103 and REPLACE with the following paragraph:

We find that it is appropriate to adopt Staff's recommended monthly usage charges and Staff's recommended commodity rate tier break-over points. However the overall revenue requirement established herein necessitates commodity rates higher than those recommended by Staff. With the rates adopted herein, the monthly bill for a customer served by a ¾" meter with average consumption will be increased from \$62.68 to \$64.09, representing an increase of \$1.41, or approximately 2.25 percent over current rates.

Page 43, Lines 13 through 25,

In each place in which the figures appear:

REPLACE "\$1.70" with "\$1.83"

REPLACE "\$2.47" with "\$2.66"

EXHIBIT B

**SUGGESTED INCOME-TAX AMENDMENT
TO RECOMMENDED OPINION AND ORDER**

REPLACE “\$3.09” with “\$3.31”

Make all other conforming changes

**SUGGESTED OPERATING MARGIN AMENDMENT
TO RECOMMENDED OPINION AND ORDER**

Page 36, Line 9,

INSERT new paragraph after paragraph 88:

89. Although we have determined that allowing income-tax expense for Sunrise would be inconsistent with the Commission's long-standing policy of denying recovery of income tax expense for pass-through entities, we do note that, in contrast to many other Arizona water utilities, Sunrise has made sufficient investment in plant to generate a substantial positive rate base. Mr. Campbell has provided Sunrise the funds needed to invest in water infrastructure, including arsenic-remediation facilities. As a result, Sunrise has an adequate rate base. Yet, by denying income-tax recovery the Commission would provide Sunrise an operating margin of just 7.43 percent, substantially less than the 10-percent operating margin the Commission traditionally provides for utilities with negative or minimal rate bases. Certainly, Sunrise should be treated no worse than these financially-distressed utilities, so we will calculate Sunrise's revenue requirement based on a 10-percent operating margin.

RENUMBER subsequent paragraphs.

Page 38, Line 21,

DELETE last sentence of existing Paragraph 91.

Page 40, Lines 20 through 22,

DELETE Paragraph 101 in its entirety.

Page 40, line 23,

EXHIBIT C

SUGGESTED OPERATING MARGIN AMENDMENT TO RECOMMENDED OPINION AND ORDER

DELETE first sentence of existing paragraph 102 and REPLACE with the following sentence:

Based on the adjustments made herein, we find that Sunrise should be permitted to recover operating income of \$143,913 and total operating expenses of \$1,295,217, for an overall revenue requirement of \$1,439,130.

Page 40, line 27,

DELETE paragraph 103 and REPLACE with the following paragraph:

We find that it is appropriate to adopt Staff's recommended monthly usage charges and Staff's recommended commodity rate tier break-over points. However the overall revenue requirement established herein necessitates commodity rates higher than those recommended by Staff. With the rates adopted herein, the monthly bill for a customer served by a ¾" meter with average consumption will be increased from \$62.68 to \$63.23, representing an increase of \$0.55, or approximately 0.88 percent over current rates.

Page 43, Lines 13 through 25,

In each place in which the figures appear:

REPLACE "\$1.70" with "\$1.80"

REPLACE "\$2.47" with "\$2.61"

REPLACE "\$3.09" with "\$3.25"

Make all other conforming changes